Group Finance Director's review

Significant growth

Chris Davies
Group Finance Director

Presentation of results

To supplement IFRS reporting, we also present our results on a normalised basis which shows the performance of the business before intangible amortisation for acquired businesses, result for the year from discontinued operations and in the prior year, US tax reform and UK restructuring. The Board believes that this gives a more comparable year-on-year indication of the operating performance of the Group and allows the users of financial statements to understand management's key performance measures. Unless otherwise noted, all references to profit measures throughout this review are for continuing operations for both the current and prior reporting period. In addition to performance measures directly observable in the Group financial statements (IFRS measures), alternative financial measures are presented that are used internally by management as key measures to assess performance. Further explanation in relation to these measures can be found on page 205.

Statutory profit

The Group again delivered a record statutory profit after tax amounting to £138.7 million (2017: £134.3m) driving basic earnings per share of 26.6 pence (2017: 25.7p), with the result in the prior year including gross profit from discontinued operations of £5.9 million following the exit of our UK rail operations. Profit after tax from continuing operations grew by 8%.

Statutory profit

Reconciliation of statutory profit to normalised operating profit	2018 £m	2017 £m
Normalised profit before tax	**220.0**	200.0
UK restructuring	**–**	(5.6)
Intangible amortisation	**(42.3)**	(38.0)
Profit before tax	**177.7**	156.4
Tax charge	**(39.0)**	(28.0)
Profit after tax from continuing operations	**138.7**	128.4
Profit from discontinued operations	**–**	5.9
Profit for the year	**138.7**	134.3

Revenue

Revenue bridge	£m
2017 revenue	2,321
Currency translation	(28)
2017 revenue at constant currency	2,293
Growth in the continuing business	84
2018 acquisitions	74
2018 revenue	2,451

Group revenue for the period was £2,450.7 million (2017: £2,321.2m), an increase of 6.9% on a constant currency basis (up 5.6% on a reported basis with £27.7 million of foreign currency losses on translation). Revenue growth of £83.5 million from our existing businesses, representing growth of 3.6%, was boosted by a further £73.7 million from acquisitions, principally in North America and Spain.

The Group has seen an improved trajectory in revenue with growth accelerating in the second half of the year. Revenue growth has been delivered across each major division with performance particularly strong in our overseas businesses. ALSA delivered a record level of revenue, growing by 11.2% in constant currency, with strong organic growth of 6.1% boosted by three acquisitions made in the year. Record passenger numbers in both Spain and Morocco, up 5.7% and 2.1% respectively, have driven strong revenue growth, while AlpyBus has also delivered very strong organic growth of 29.1% following a successful ski season and new services during the summer months. Growth in Spain reflects good performances across our services in regional, urban and long haul, with a strong summer season in long haul reversing the small decline seen in the first half of the year, with our increasingly sophisticated Revenue Management System ('RMS') driving growth in passengers and average ticket price.

Our business in North America delivered revenue growth of 8.0% on a constant currency basis, with organic growth benefiting from the 2018/2019 bidding season in which we achieved an average price increase of 3.7% across the entire portfolio and 6.5% on those contracts up for bid and renewal. This growth was augmented by seven acquisitions in the year. Our Transit business is now delivering annualised revenue of over $350 million, growing by 17% in the year.

Our UK business delivered a particularly strong performance in the second half of the year, with an improving trajectory delivering revenue growth of 2.8% for the year as a whole. This was driven predominantly by our coach business where revenue increased by 5.4% overall and by 7.4% in the core operations, with RMS helping to drive record revenue and passenger numbers. Targeted marketing campaigns and significant levels of rail disruption also helped to boost growth. Our UK commercial bus business grew revenue by 0.8%, driven by commercial passenger growth of 1.1%, benefiting from the continuation of the low fare zones together with the launch of contactless payment in 2018 and growing penetration of m-tickets. This growth comes despite a reduction in mileage of 2.9%, meaning revenue per mile increased by 4.0%.

The fall in revenue in German Rail reflects the catch-up revenues recognised in 2017 coupled with a change in presentation of income and cost receivable from the local authority. Underlying revenue grew by 5.4%.

Normalised profit

Profit bridge for the continuing operations	£m
2017 normalised operating profit (as reported)	242
Currency	(3)
Normalised operating profit at constant currency	239
Growth in continuing business	29
2018 Acquisitions	17
Fuel	19
Driver wages in North America and Spain	(16)
Maintenance and safety investment	(12)
General cost inflation	(24)
Other	6
2018 normalised operating profit	258

Group normalised operating profit increased by 7.7% to £257.7 million on a constant currency basis, up 6.7% on a reported basis (2017: £241.5m), after the adverse impact of £3 million of currency translation driven by the strengthening of Sterling against the US Dollar. The Group delivered a robust performance from its existing businesses, as the drivers of revenue growth noted above flowed through to a £29 million contribution to profit. This was supplemented by the 11 acquisitions made during the year.

We benefited by £19 million from lower hedged fuel prices but this was mostly offset by above-inflation driver wage increases, predominantly in North America. During the year, we increased investment in maintenance and safety programmes in North America, and whilst this creates a short-term drag on North American operating margin, we will reap the rewards in the medium term.

General cost inflation across the Group amounted to £24 million.

The Group continues to evaluate strategic options for its UK property portfolio. Following on from our disposal of Sipson Road in 2017, we completed sale and leaseback transactions on our depot in Dundee and three depots in the West Midlands for cash consideration of £16.5 million. The incremental profit impact of these transactions was £5.2 million and is reported within the 'other' movement above.

Segmental profit performance

	2018 Local currency	2017 Local currency
ALSA €m	**119.1**	108.3
North America US $m	**129.4**	121.6
German Rail €m	**3.4**	5.9

	2018 £m	2017 £m
ALSA	**105.3**	94.9
North America	**96.9**	94.3
UK	**79.9**	70.9
German Rail	**3.0**	5.2
Central functions	**(27.4)**	(23.8)
Group normalised operating profit	**257.7**	241.5

We have delivered profit growth across each of our core businesses, with the strongest performance in our UK business, where normalised operating profit increased by 12.6%, reflecting strong operating performances in both our bus and coach businesses, with operating margin improving by 120 basis points to 13.8%. This strong performance reflects record revenue in our core coach business, together with cost efficiencies, new routes, network reviews, and lower fuel costs as well as the profit on disposal of property noted above.

ALSA also delivered a strong performance with a record profit of £105.3 million, with a normalised operating profit increase of 9.9% on a constant currency basis, driven by a combination of strong organic growth in Spain and Morocco, together with the benefit of acquisitions made in 2017 and 2018. This was further augmented by cost efficiencies and lower fuel costs which largely offset cost inflation. ALSA has benefited from a one-off gain on the sale of taxi licences which was broadly offset with a one-off adjustment to the timing of revenue recognition for certain contracts as part of the move to IFRS 15.

North America delivered a record profit of £96.9 million, with normalised operating profit increasing by 6.4% on a constant currency basis driven by strong performance in the acquisitions made in 2017 and 2018. Driver wage inflation of 3.5%, along with increased investment in maintenance programmes and safety technology, has driven a 20 basis point decline in 2018 profit margin, but positions the business for higher return in the medium term.

Our German Rail operations delivered an operating profit contribution of €3.4 million (2017: €5.9m), representing an operating margin of 4.4%, with profit in 2017 boosted by the catch-up of revenue not previously recognised.

Central costs have increased by £3.6 million, reflecting amongst other things, increased investment in operational excellence and talent teams, as well as the full year effect of our international/commercial development team in 2018.

Group normalised operating profit margin grew by 10 basis points at 10.5% (2017: 10.4%).

Summary income statement

	2018 £m	2017 £m
Revenue	**2,450.7**	2,321.2
Operating costs	**(2,193.0)**	(2,079.7)
Normalised operating profit	**257.7**	241.5
Share of results from associates	**0.9**	(3.5)
Net finance costs	**(38.6)**	(38.0)
Normalised profit before tax	**220.0**	200.0
Tax	**(49.0)**	(48.0)
Normalised profit after tax	**171.0**	152.0

Net finance costs were stable at £38.6 million (2017: £38.0m).

We recorded a profit of £0.9 million (2017: loss of £3.5m) from associates and joint ventures, with the loss last year reflecting the write-down of our investment in a minority stake in Deutsche Touring Group, a German partner in Eurolines, which entered into administration in 2017.

Normalised profit before tax of £220.0 million represents growth of 11.3% on a constant currency basis, up 10.0% on a reported basis (2017: £200.0m).

The normalised tax charge from continuing operations was £49.0 million (2017: £48.0m), a normalised effective tax rate of 22.3%, (2017: 24.0%) in line with previous guidance. The decrease in the normalised effective tax rate is largely the result of mix of profits, with a significant proportion of profits coming from the US where the federal corporate income tax rate reduced from 35% to 21%, effective from 1 January 2018.

Normalised basic earnings per share were 32.9 pence (2017: 29.1p), an increase of 13.1%.

Return on Capital Employed ('ROCE')

ROCE is a key performance measure for the Group, guiding how we deploy capital resources and as such is a key component of executive incentives. ROCE has increased to 12.4% (2017: 11.9%), demonstrating our disciplined approach to capital allocation and balance sheet management and the accretive impact of our high return acquisitions.

Reconciliation of ROCE	2018 £m
Group statutory operating profit	**215.4**
Intangible amortisation for acquired businesses	**42.3**
Return – Normalised Group operating profit	**257.7**
Average net assets	**1,181.8**
Remove: Average net debt	**919.7**
Remove: Average derivatives, excluding amounts within net debt	**4.7**
Foreign exchange adjustment	**(22.2)**
Average capital employed	**2,084.0**
Return on capital employed	**12.4%**

Cash management

The Group delivered £198.6 million of free cash flow in the period (2017: £146.4m), an increase of £52.2 million, which constitutes free cash flow conversion of 77%, creating a solid platform for investing in growth and paying dividends.

Free cash flow	2018 £m	2017 £m
Continuing normalised operating profit	**257.7**	241.5
Depreciation and other non-cash items	**144.4**	135.5
EBITDA	**402.1**	377.0
Net maintenance capital expenditure	**(123.9)**	(165.2)
Working capital movement	**(17.5)**	4.8
Pension contributions above normal charge	**(7.4)**	(5.0)
Operating cash flow	**253.3**	211.6
Net interest paid	**(33.6)**	(50.6)
Tax paid	**(21.1)**	(14.6)
Free cash flow	**198.6**	146.4

The Group delivered £402.1 million of EBITDA in the period (2017: £377.0m), an increase of £25.1 million. Net maintenance capital expenditure payments reduced by £41.3 million to £123.9 million, driven by sale and leaseback transactions, most notably the UK depots noted above. Going forward, we expect maintenance capital expenditure to revert to a normalised level of around 1.1 to 1.2 times depreciation. The working capital outflow of £17.5 million in 2018 compares with an inflow of nearly £5 million in the prior year, which partly reflected catch-up receipts in our German Rail business in 2017. The outflow in 2018 reflects a return to normal working capital movements associated with a growing business. The combination of these movements delivered operating cash flow of £253.3 million (2017: £211.6m), an increase of £41.7 million.

The Group also delivered a £17.0 million reduction in net interest paid, returning to a normalised interest payment in the period, with 2017 reflecting a double coupon payment following the bond issue in that year.

The resulting free cash flow of £198.6 million (2017: £146.4m) represents an increase of £52.2 million but we would expect free cash flow to normalise at around £150 million to £160 million in 2019.

Reconciliation of free cash flow to net cash flow from operating activities	2018 £m
Free cash flow	**198.6**
Add: Operating cash flows from discontinued operations	**0.4**
Remove: Net maintenance capital expenditure	**123.9**
Remove: Movements in arrangement fees	**0.3**
Remove: Profit on disposal of tangible and intangible assets	**(16.7)**
Other movements	**0.3**
Net cash flow from operating activities	**306.8**

Net funds flow	2018 £m	2017 £m
Free cash flow	**198.6**	146.4
Net growth capital expenditure	**(5.8)**	(13.2)
Net inflow from discontinued operations	**0.4**	27.5
Acquisitions (net of cash acquired)	**(154.5)**	(101.5)
Dividends	**(70.8)**	(64.7)
Other, including foreign exchange	**(31.5)**	(4.4)
Net funds flow	**(63.6)**	(9.9)
Net debt	**(951.5)**	(887.9)

Growth capital expenditure during the period of £5.8 million included investment in digital and e-commerce initiatives in the UK, new fleet for the minicab business in Spain and costs associated with the mobilisation of our RRX rail contract in Germany.

Cash inflow from discontinued operations of £27.5 million in the prior year relates to the exit of the UK rail business.

We have continued our strategy of making selective acquisitions where the returns and strategic fit justify the investment, and we completed 11 such investments in the year: seven in our North American division, three in ALSA and one in our UK coach business. Total net consideration for these acquisitions was £142.8 million of which £26.8 million is deferred into future years. £38.5 million of deferred consideration relating to acquisitions completed in prior years was settled in 2018, resulting in a total net funds outflow in the period of £154.5 million. We continue to deliver strong performances from our acquisitions, delivering returns on invested capital of at least 15% in the first full year after acquisition.

Other items include £21.8 million relating to the retranslation of foreign currency debt balances and the maturity of some foreign exchange contracts.

Net funds flow for the period was an outflow of £63.6 million (2017: outflow £9.9m), resulting in year end net debt of £951.5 million (2017: £887.9m).

Dividend

National Express's dividend policy is to cover the dividend at least two times by normalised earnings. In considering the level of the dividend to declare, the Board considers three principal factors, in addition to level of cover:

1. available distributable reserves;
2. in-year free cash flow generation; and
3. company gearing and indebtedness.

In line with the interim dividend, the Board has proposed a 10% increase in the final dividend to 10.17 pence, to give a full year dividend of 14.86 pence at 2.2 times cover.

Treasury management

The Group maintains a prudent approach to its financing and is committed to an investment grade credit rating. The Board's policy is to target a level of debt that allows for disciplined investment and ample headroom on its covenants, with net debt to EBITDA of 2.0 times to 2.5 times over the medium-term. Moody's credit rating agency upgraded its investment grade rating to Baa2 during the year while Fitch credit rating agency re-affirmed its investment grade credit rating at BBB-/stable.

The Group's key accounting debt ratios at 31 December 2018 were as follows:

- Our bank covenant for gearing is not to exceed 3.5 times net debt to EBITDA – in 2018 the gearing ratio was 2.3 times EBITDA (31 Dec 2017: 2.3x);
- Our bank covenant for the interest cover ratio is EBITDA not to be less than 3.5 times interest – in 2018 the interest cover ratio was 10.5 times interest (31 Dec 2017: 10.2x).

The Group has a strong funding platform that underpins the delivery of its strategy. Core funding is provided from non-bank sources to provide improved certainty and maturity of funding. In April 2018, the Group extended its £527 million committed bank facilities to mature in April 2023 (with two one year extension options). In January 2019, the Group entered into a new £500 million bridge-to-bond facility in anticipation of the refinancing of the Group's €250 million floating rate note maturing in May 2020 and £225 million bond maturing in June 2020. The facility is for an initial period of 18 months and includes committed options to extend the maturity date until January 2022. This facility gives the Group significant flexibility, enabling us to choose the optimum moment to refinance, taking into account the prevailing low interest rate environment and potential future rate developments, without incurring punitive refinancing charges.

At 31 December 2018, the Group had £1.6 billion of debt capital and committed facilities, comprised the £225 million Sterling bond and €250 million Floating Rate Note both maturing in 2020; a private placement of €78 million maturing in 2021; the £527 million of Revolving Credit Facility ('RCF') maturing in 2023; a £400 million Sterling bond maturing in 2023 and £143 million of finance leases. At 31 December 2018, the Group's RCF was undrawn with £644 million in cash and undrawn committed facilities available.

At 31 December 2018, the Group had foreign currency debt and swaps held as net investment hedges: these help mitigate volatility in the foreign currency translation of our overseas net assets. The Group also hedges its exposure to interest rate movements to maintain an appropriate balance between fixed and floating interest rates on borrowings. It has therefore entered into a series of swaps that have the effect of converting fixed rate debt to floating rate debt. The net effect of these transactions was that, at 31 December 2018, the proportion of Group debt at floating rates was 37% (2017: 43%).

Working capital management

For a number of years, the Group has used various facilities to manage both payables and receivables. We use non-recourse factoring arrangements across the Group on receivables and advance payments. The total draw down in 2018 was £88.7m. In respect of fleet purchases, we have extended payment terms facilities in place with our major vehicle suppliers. The amount payable as at the balance sheet date was £160.3 million.

Group tax policy

We pursue a prudent approach to our tax affairs which are aligned to business transactions and economic activity. We have a constructive and good working relationship with the tax authorities in the countries in which we operate and there are no outstanding tax audits in any of our main three markets of the UK, Spain and the USA.

The Group's tax strategy is published on the Group website in accordance with recent UK tax law.

Pensions

The Group's principal defined benefit pension schemes are all in the UK. The combined deficit under IAS 19 at 31 December 2018 was £116.8 million (Dec 2017: £94.5m).

The two principal plans are the UK Group scheme, which closed to new accrual in 2011, and the West Midlands Bus plan ('WM Bus'), which remains open to accrual for existing active members only. The overall level of deficit contributions will be around £8 million in total per annum until 2020.

In October 2018, the Group scheme executed an insurance "buy-in" with Rothsay Life for 100% of the future obligations of the funds of the UK Group scheme. Whilst this results in a reduction to the actuarial surplus, this materially derisked the Group's balance sheet, as any change in future liabilities will be met by the insurance company.

The IAS 19 valuations for the principal schemes at 31 December 2018 were as follows:

- WM Bus: £127.3 million deficit (2017: £133.8m deficit)
- UK Group scheme: £14.9 million surplus (2017: £43.2m surplus)

Fuel costs

The Group consumes approximately 230 million litres of fuel each year for which it bears pricing risk (ie. there is no direct fuel escalator in the contract or concession price). Fuel costs represented a total cost to the Group in 2018 of £160 million (approximately 7% of related revenue), at an average fuel component cost (ie. excluding delivery and taxes) of 34.9 pence per litre. The Group pursues a forward fuel buying policy in order to secure a high degree of certainty in its planning. This policy is to hedge fully a minimum of 15 months' addressable consumption against movements in price of the underlying commodity, together with at least 50% of the next nine months' consumption in the contract businesses. Currently, the Group is 100% fixed for 2019 at an average price of 37.4 pence per litre, 71% fixed for 2020 at an average price of 35.7 pence and 29% fixed for 2021 at 37.6 pence. Based on this, year-on-year fuel costs for the same mileage will be around £6 million more in 2019.

Impact of new accounting standards – IFRS 9, 15 and 16

Two new accounting standards came into effect on 1 January 2018 (IFRS 9 and IFRS 15), with a third, IFRS 16, coming into effect on 1 January 2019.

IFRS 9 'Financial Instruments' addresses accounting for financial assets and financial liabilities including new rules for hedge accounting and a new impairment model for financial assets. The Group has reviewed its existing financial assets and liabilities accounting and has made a number of transitional adjustments, including an increase in the impairment provision for trade and other receivables. The net impact of these adjustments is a reduction in net assets of £13.5 million, with full details in note 2 in the financial statements.

IFRS 15 'Revenue from Contracts with Customers' is based on the principle that revenue is recognised when control of a good or service transfers to a customer. On transition, this has resulted in a net reduction in net assets of £17.7 million, with full details in note 2 in the financial statements.

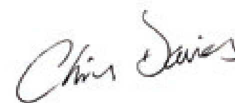
IFRS 16 'Leases' will primarily affect the accounting for the Group's operating leases and will result in an increase in the number of leases being recognised on the balance sheet as the distinction between operating and finance leases is removed. The new standard came into effect on 1 January 2019. As a result we expect to recognise right-of-use assets and lease liabilities of around £190-210 million. The impact on EBITDA is expected to be an increase of around £60 million and hence an increase in gearing of less than 0.2 times. Further details are provided in note 2 in the financial statements.

Brexit

The Directors have determined that the level of uncertainty surrounding Brexit requires the Group to highlight it as a specific principal risk. Whilst, at the time of writing, the likelihood of a disorderly Brexit appears to be increasing, given the diversified nature of our business model and the limited exposure to cross-border trade, we do not believe that Brexit poses a material threat to the Group. We no longer run scheduled operations between the UK and the Continent, therefore the main Brexit risk specific to the Group is that inbound and outbound airport travel in our UK coach business may be impacted should air travel be materially reduced due to restrictions or currency fluctuation. Our Spanish business carries very few UK nationals, making up only around 0.1% of total passenger revenue. We purchase some vehicles from European manufacturers for UK operations although we have good working relationships with both these and alternative UK suppliers to mitigate any long-term impact should further Sterling depreciation materially increase purchase cost. For the purposes of viability testing, we have modelled a hard Brexit in conjunction with other principal risks and remain confident that we have suitable mitigation plans in place however Brexit eventually unfolds.

Summary

The strong financial performance delivered in 2018, coupled with the additional financing facilities and continued prudent balance sheet management, further augment the Group's robust financial position. We remain confident about the prospects for the year ahead.



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